

## Internal Revenue Service

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Department of the Treasury  
Washington, DC 20224

Third Party Communication: None  
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Person To Contact:  
 , ID No.

Telephone Number:

Refer Reply To:  
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PLR-131036-07

Date:  
December 28, 2007

### Legend

Distributing =

Controlled =

State A =

Business B =

City X =

City Y =

Date 1 =

Shareholder C =

Person D =

Person E =

Day G =

H% =

Dear \_\_\_\_\_ :

We respond to your June 19, 2007 request for rulings regarding certain Federal income tax consequences of a proposed transaction (the "Transaction"). The information submitted in that request and in your later correspondences dated August 17, 2007, November 1, 2007 and December 20, 2007, is summarized below.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer and accompanied by a Penalties of Perjury statement executed by an appropriate party. This Office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

Moreover, no information provided by the taxpayer has been reviewed and no determination has been made regarding whether the Transaction: (i) satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations, (ii) is used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (see § 355(a)(1)(B) of the Internal Revenue Code and § 1.355-2(d)), or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation (see § 355(e)(2)(A)(ii) and § 1.355-7).

#### Facts

Distributing is a State A corporation that directly conducts Business B in City X and City Y of State A. Distributing was incorporated on Date 1 and is taxed as a subchapter S corporation for Federal income tax purposes. It is a Day G year taxpayer that uses the accrual method of accounting. Financial information has been received indicating that Distributing has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years. Distributing has a single class of voting common stock all of which is owned by Shareholder C.

Person D and Person E (the "Key Employee(s)") in the City X and City Y business locations, respectively, seek an ownership interest in Business B at their respective locations. Each Key Employee is responsible for the business productivity in his respective location and wants to participate in the profitability of each location for which he is responsible. In order to provide incentives to the Key Employees to increase

profitability, each Key Employee, after the separation of assets and the spin off, will be able to purchase stock in the respective corporation for which he is responsible.

To effectuate these goals, Distributing seeks to engage in the following Transaction:

Distributing will form Controlled, which will elect to be taxed as a Subchapter S corporation. Distributing will transfer the City Y Business B assets to Controlled and spin off Controlled to Shareholder C (the Spin Off). Controlled and Distributing will be accrual method taxpayers.

After the Spin Off, Person D will purchase up to H% of the Distributing stock and Person E will purchase up to H% of the Controlled stock.

### Representations

The taxpayers have made the following representations in connection with the Transaction described above:

- a) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- b) The five years of financial information submitted on behalf of Distributing is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- c) The five years of financial information submitted on behalf of Controlled is representative of Distributing's present City Y location operation, and with regard to Distributing's operations in the City Y location, there have been no substantial operational changes since the date of the last financial statements submitted.
- d) Following the Transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees, except that Distributing and Controlled will share the services of Shareholder C. Distributing and Controlled will each pay Shareholder C directly for the value of his services.
- e) The distribution of the stock, or stock and securities, of Controlled is carried out for the following corporate business purpose: to incentivize a Key Employee at each business location by providing him an equity interest in the business thereby improving overall profitability of the business. The Key Employees are the managers at each of Distributing's business locations in City X and City Y. To properly incentivize each manager, it is necessary that the equity interest that

each manager receives reflects an equity interest in only the business location for which that manager is responsible. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.

- f) The Transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- g) For purposes of § 355(d), immediately after the Spin Off, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the value of the total combined shares of all classes of Distributing stock, that was acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Spin Off.
- h) For purposes of § 355(d), immediately after the Spin Off, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the value of the total combined shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Spin Off, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Spin Off.
- i) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing equals or exceeds the sum of the liabilities assumed (within the meaning of section 357(d)) by Controlled plus any liabilities to which the transferred assets are subject.
- j) The liabilities assumed (as determined under section 357(d)) in the Transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.
- k) No investment credit under section 46 has been (or will be) claimed with respect to any property being transferred between Distributing and Controlled.
- l) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Transaction.
- m) No income items, including accounts receivable or any item resulting from a sale, exchange or disposition of property, that would have resulted in income to Distributing, and no items of expense will be transferred to Controlled if

Controlled has earned the right to receive the income or could claim a deduction for the expense under the accrual or similar method of accounting.

- n) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.
- o) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- p) Each of the following acquisitions of stock of Distributing or Controlled (including any predecessor or successor of any such corporation) is or may be part of a plan or series of related transactions (within the meaning of § 1.355-7) that includes the distribution of Controlled stock: H% of the Distributing stock will be sold by Distributing to a Key Employee at the City X business location and H% of the Controlled stock will be sold by Controlled to a Key Employee at the City Y business location. Taking all of these acquisitions into account, stock representing a 50-percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation) will not be acquired by any person or persons.
- q) No two parties to the Transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- r) Neither Distributing nor Controlled will be a disqualified investment corporation (within the meaning of § 355(g)(2)).

## Rulings

Based solely on the information submitted and on the representations set forth above, we rule as follows with respect to the Transaction:

- 1) The transfer by Distributing to Controlled of part of its assets in exchange for all of the Controlled stock and assumption of liabilities followed by the distribution of all the Controlled stock to Shareholder C will constitute a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled each will be "a party to a reorganization" within the meaning of § 368(b).
- 2) Distributing will recognize no gain or loss upon the transfer of assets to Controlled and the assumption of liabilities by Controlled upon the transfer of assets (See Code §§ 361(a) and 357(a)).
- 3) Controlled will recognize no gain or loss on the receipt of Distributing's assets in exchange for respective Controlled stock (§ 1032(a)).

- 4) Controlled's basis in each asset received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the Transaction (§ 362(b)).
- 5) Controlled's holding period of each asset received from Distributing will include the period during which Distributing held such asset (§ 1223(2)).
- 6) Shareholder C will recognize no gain or loss (and no amount will otherwise be included in Shareholder C's income) upon receipt of the Controlled stock (§ 355(a)).
- 7) Distributing will recognize no gain or loss on the distribution of the Controlled stock to Shareholder C (§ 361(c)).
- 8) The aggregate basis of the Distributing and Controlled stock in the hands of Shareholder C will equal the basis of the Distributing stock held prior to the distribution (§ 358(a)).
- 9) Shareholder C's holding period of the Controlled stock received in the distribution will include the holding period of the Distributing stock held, provided that the Distributing stock is held as a capital asset on the date of the exchange (§ 1223(1)).
- 10) Distributing's earnings and profits will be allocated between Distributing and Controlled in accordance with § 312(h) and § 1.312-10(a).

#### Caveats

No opinion is expressed about the tax treatment of the Transaction under other provisions of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the Transaction that are not specifically covered by the above rulings.

In particular, no opinion is expressed regarding: (i) whether the distribution satisfies the business purpose requirement of § 1.355-2(b); (ii) whether the Transaction is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both; and (iii) whether the distribution and an acquisition or acquisitions are part of a plan (or series of related transactions) under § 355(e)(2)(A)(ii).

Further, no opinion is expressed concerning whether Distributing's S election is valid or will continue to be valid; whether Controlled is otherwise eligible, or will continue to be eligible, to be taxed as a subchapter S corporation; and whether Controlled's election to

be taxed as subchapter S corporation will be valid or will continue to be valid under Code § 1362(a).

Other than the rulings provided above, no opinion is expressed as to the tax treatment of the individual purchases of the Distributing and Controlled stock by the Key Employees after the Spin Off.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

George R. Johnson

George R. Johnson  
Assistant to the Chief, Branch 6  
Office of Associate Chief Counsel  
(Corporate)

CC: